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SUBJECT: Government Incentives Diminishing in South China Investment Environment

REF: A) 2007 GUANGZHOU 1094; B) SHANGHAI 0029

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¶1. (SBU) Summary: Government policies encouraging investment in south China have significantly diminished and are no longer a major factor in most foreign and domestic companies' investment decisions here, according to local manufacturers who met with visiting U.S. International Trade Commission (ITC) analysts. China's regulatory environment has grown stricter in recent years, and many firms, especially labor-intensive manufactures like textile makers, complained that rising labor costs and the appreciation of the renminbi (RMB) against the dollar have dramatically reduced profit margins. Currently, the government's main tool for influencing new investment decisions is control of land resources. Even as textile manufacturers describe plans to move production elsewhere, south China's high-end manufacturers in automobile and telecommunications equipment manufacturing see a bright future ahead with plans for expansion. End summary.

Incentives Disappearing, Regulation Tightening
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¶2. (SBU) Manufacturers in south China seem to agree that tax incentives and export subsidies previously used by the Chinese government to encourage investment, both foreign and domestic, are no longer major factors in corporate decision making. This was a theme echoed repeatedly by the telecommunications equipment, textile and automotive manufacturers visited by U.S. ITC analysts in late January as part of a second visit to examine China's economic policies on trade and investment. Corporate decisions to build new factories or expand existing ones in south China are now based more on factors like production costs, availability and cost of labor, transportation, infrastructure, and the quality and availability of suppliers, according to Zhai Xiaoping, General Manager of China Silk Enterprise Ltd. He described this as a major change from 5 or 10 years ago when government connections and tax incentives also factored significantly in every investment decision. Instead, elimination of most incentives has made it more difficult for manufacturers who previously relied on favorable treatment to maintain profit margins.

¶3. (SBU) Stricter regulations have also created challenges for some manufacturers. China's new labor law and tighter enforcement of environmental regulations have raised costs for some companies not already in compliance as they struggle to raise standards. However, Henry Tan, CEO of Luen Thai Holdings, noted companies that already meet the regulations have benefited from the negative effect on

competitors.

Rising Wages, Appreciating RMB Hit Hard
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¶4. (SBU) Managers across industries complained about increasing labor costs and the appreciation of the RMB, but the impact appears to be most severe for labor-intensive manufacturing like the textiles industry. (Comment: The comments of textile manufacturers in the Pearl River Delta were consistent with those from Yangtze River Delta manufacturers as reported in ref B. End comment.) Textile executives Zhai and Tan both said these factors had cut their profit margins to as low as 2 or 3 percent. Zhai explained that China Silk's attempt to cut costs by opening a new factory in Zhejiang province in 2001 only provided short-term relief. As wages in Zhejiang rose to levels approaching those in the Pearl River Delta, higher costs for transportation eliminated the advantage of the new location. Tan told us that Luen Thai would continue shifting low-end production from China to Southeast Asia and Bangladesh. He noted that while China still maintained advantages for production of quick-turnaround, seasonal and fashion clothing, labor costs in Vietnam and Bangladesh were 20-25 percent of China's.

Government Allocation of Land Rights Remains Key
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¶5. (SBU) Manufacturing executives also agreed that the government's control of land allocation was still a key factor in some investment decisions. Huang Zhixiong, Senior Manager of Planning at Guangzhou Toyota described government support for a project as critical to the deal's success. Without such support, land would be difficult or impossible to secure. Li Zanjie, the firm's Marketing Manager said subsidized rent was a significant incentive for his firm's decision



to establish a joint-venture in Guangzhou. However, he also pointed out that the presence of an existing supply chain serving one French and two other Japanese automotive manufacturing joint ventures was the primary reason to begin production here four years ago. In addition, he commented that China's new labor law, environmental regulations and R&D investment requirement did not have much impact on Guangzhou Toyota's operations because the requirements were consistent with Toyota's own internal policies. The Guangzhou joint venture currently produces 200,000 Camry vehicles per year and has another production line under construction.

High-Tech Manufacturers Optimistic
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¶6. (SBU) High-technology manufacturers in the telecommunications equipment industry told us that despite diminishing government incentives their operations are expanding and exports are growing. Guangdong Nortel Director of Research and Development Rick Li described his company's plans to further expand research and development (R&D) operations in China. Nortel currently employs 1,300 engineers, approximately 10 per cent of Canadian company's global R&D workforce, in the south China joint venture. The low cost of conducting R&D is the main reason for Nortel's initial investment and ongoing expansion here. Li said the firm's Chinese joint-venture partners have played an important role in its success. However, the company only conducts research on certain product lines inside China, for fear of losing valuable intellectual property if sensitive technology for other key products were brought into the country.

¶7. (SBU) Carl Liu of Huawei Technologies and Jiang Xiangyang of ZTE Corporation, two of China's leading telecom equipment manufacturers, separately described strong export growth for virtually all of their product lines. Huawei's international sales accounted for 70 percent of total revenue in 2007 compared to 60 percent for ZTE. Both Liu and Jiang emphasized that labor costs for Chinese high-tech workers were much lower than the salaries they paid R&D staffs in the United States, India and Europe. Managers of both firms pointed out that expiring tax incentives and export rebates have not affected their companies but could affect firms like Ericsson or

Nokia, which may have based their decisions to invest in China in part on those benefits.

¶8. (U) This cable was not reviewed by the ITC delegation.

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